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China's New Foreign Investment Incentives: A Small Step in the Right Direction [redacted] 25X1

Summary

Last month, Beijing announced its long-promised and much-touted new guidelines for encouraging foreign investment. Designed to reverse the recent decline in overseas investment commitments, the regulations are an attempt by Beijing to channel foreign investment into priority areas. Consequently, joint ventures that produce primarily for export or introduce advanced technology are the principal beneficiaries. The policies are less far reaching than the rhetoric which preceded them, however, and offer little relief for the problems of repatriating foreign exchange and access to China's domestic market--the two issues of most concern to foreign investors. Even so, the measures represent a step in the right direction, and should improve China's investment climate. The high-level attention afforded these changes, moreover, suggests significant pressure will be applied at the grassroots level to encourage successful implementation and experimentation. Successful local programs likely will serve as models for future changes in national policy. [redacted] 25X1

This memorandum was prepared by [redacted] Office of East Asian Analysis. 25X1
Information available as of 19 November 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Trade and Technology Branch, China Division, OEA [redacted] 25X1

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New Regulations Unveiled

Following a flurry of pronouncements by high-level Chinese officials, on 11 October the State Council unveiled new regulations to encourage foreign investment. Long anticipated, the policies seek to reverse the country's deteriorating investment climate, which, according to Beijing, led to a 20-percent decline in overseas investment commitments for the first six months of this year as compared with the same period in 1985. The US Consulate in Hong Kong believes the decline was even greater, however, with its figures showing the value of foreign investment commitments dropping 42 percent during the first half of 1986 to $1.24 billion. [redacted]

Included in the new guidelines are a number of provisions affecting all foreign enterprises: 25X1

- Guaranteed autonomy over production, funds, inputs, wage and bonus levels, and personnel--including the right to hire and fire workers and senior managers.

- Import license exemptions for machinery and equipment, vehicles, raw materials, and spare parts required for production.

- Export of production directly or through agents, with export licenses, where applicable, obtained at six-month intervals rather than on a case-by-case basis.

- Exemption from income taxes payable on profits if subsequently reinvested in expanding or establishing export-oriented or advanced technology enterprises.

- Authority for foreign enterprises to adjust foreign exchange surpluses and deficits among themselves.

- Maximum three-month waiting period for official responses to investment matters that require approval by state and/or local departments. [redacted] 25X1

Granting foreign investors autonomy over their enterprises mirrors many of the domestic economic reforms implemented in recent years, such as labor and enterprise management reforms. [redacted] 25X1

In addition to these across-the-board incentives for all foreign-funded enterprises, export-oriented and advanced technology enterprises are singled out for special treatment that includes:

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* Exemption from the payment of state wage subsidies to Chinese employees with the exception of labor insurance, welfare, and housing.

* Reduction and standardization of site use fees.

* Priority status for the provision of water, electricity, transportation services and communication facilities at rates on par with those paid by state enterprises.

* Preferential access to short-term loans.

* Reduced income taxes after the expiration of applicable tax holidays as well as income tax exemptions on profits remitted abroad. 25X1

More Regional Competition for Investment

The State Economic Commission has encouraged localities to experiment with the new guidelines, and they have responded with added enticements to encourage foreign investment. Ironically, excessive diversity could lead to less certainty and more confusion for foreign investors who already complain about the lack of consistency in China's investment climate. In most cases, however, the local incentives offer only minor variations of the central regulations, particularly where the regulations contain specific references to local government discretion--for example, further reductions in local taxes and site use fees. In several instances, however, the critical issue of foreign exchange was treated in more detail. For example:

* Investment incentives in Liaoning Province--a key region for technical renovation during the Seventh Five-Year Plan--outline options available to foreign-funded enterprises with foreign exchange deficits. These include providing local government funds to cover temporary foreign exchange imbalances and priority consideration for access to the domestic market for sales--at least partially in foreign exchange--of previously imported goods.

* In Guangzhou, in addition to permitting foreign exchange adjustments among foreign enterprises, various local government departments are empowered to use their own surplus foreign exchange to assist technologically advanced enterprises with foreign exchange shortages. Import substitution is also encouraged among all foreign enterprises, payable in foreign exchange and classified as "exports"--an important consideration for helping export-oriented enterprises maintain their stipulated export level to qualify for preferential treatment.

* In recent discussions with US Consulate officials, the Shanghai branch of the State Administration for Exchange Control (SAEC) asserted its ability and willingness, on a regular basis, to authorize conversion of renminbi profits into foreign exchange for purposes of repatriation. If implemented, this would mark a major departure from current practices. Shanghai officials have already been experimenting with several other measures to ease foreign exchange shortages for joint ventures, including a widely publicized SAEC-arranged currency swap

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last July between a Sino-US joint venture short of foreign exchange and a Sino-Hong Kong venture with excess foreign exchange. [redacted] 25X1

The Scorecard

The new regulations represent a positive step for improving China's investment climate, but fall short of the advance rhetoric and fail to adequately address the major impediments faced by foreign investors--access to the domestic market and access to foreign exchange to remit profits. According to the US Embassy, the new regulations were probably preceded by considerable debate among the top leadership on how fast and how far to go. In this context, concerns over the country's continuing foreign exchange shortages probably had a dampening effect on immediate efforts to resolve foreign exchange-related problems.[1] We believe the provision allowing foreign enterprises to adjust their foreign exchange balances among themselves--under the watchful eye of the relevant foreign exchange department--may have been a concession to those in the leadership who argued against more liberal provisions in light of the country's foreign exchange shortage. [redacted] 25X1

Beijing also may have dictated limits to the supplemental guidelines offered by the local governments, according to the US Consulate in Guangzhou. The final version of Guangzhou's investment guidelines omitted a provision allowing a foreign-funded enterprise to convert renminbi profits into foreign exchange--up to the level of foreign exchange equity capital invested by the enterprise--for overseas remittance. The omission of this provision--disclosed to US officials before the public announcement--may indicate Beijing's interference in the local incentive offerings. It also may indicate that the stated willingness of Shanghai officials to convert renminbi profits into foreign exchange on a regular basis for foreign enterprises could also be thwarted by Beijing. Overall, however, the regional efforts to address the foreign exchange issue bode well for continued efforts on an individual basis--local government and local foreign investor--for solving one of the foreign investors' most pressing problems. [redacted] 25X1

How the regulations are implemented at the local level will be a key indicator for assessing the impact of these new incentives. The high-level attention afforded this issue suggests that significant pressure is being applied at the grassroots level to encourage success. Different interpretations of the regulations at the various bureaucratic levels, however, may create inconsistencies that could be deterimental to the investment climate in China. Consequently, the investment group established by the State Council in early October and headed by State Councillor Gu Mu will probably play an important oversight role in monitoring overall implementation. Moreover, the new guidelines provide a framework for appeal by the foreign investor against indiscriminate treatment, a process that reaches from the local level economic committees all the way

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[1] China suffered a severe depletion of foreign exchange reserves over the last year and a half, with reserves falling from a high of $16.7 billion at yearend 1984 to a current level of $10.5 billion. Attributed largely to rampant imports, Beijing imposed tighter foreign exchange controls in March 1985. [redacted] 25X1

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to the State Economic Commission. [redacted] 25X1

Although the measures will provide relief from many of the fees and taxes burdening foreign enterprises in China, they fall short of the "bold measures" promised by the leadership. Early indications that the new guidelines would permit more import substitution opportunities for foreign enterprises that would, in addition to providing an opening to the domestic market, help foreign investors balance their foreign exchange accounts proved untrue. Rumors that the maximum length for cooperative venture agreements would be changed from 30 to 50 years also failed to materialize. [redacted] 25X1

Despite the initial disappointment among foreign investors, however, we believe foreign investment commitments will improve slightly in the near term. The publicity surrounding the regulations and the recent resolution of problems in the AMC Jeep joint venture will reassure investors of Beijing's commitment to foster successful relationships with foreign-funded enterprises. An initial increase in investment, however, probably will represent planned investments that have been postponed in anticipation of more favorable regulations. According to the US Consulate in Hong Kong, the decline in foreign investment in the first half of 1986 reflects, in part, such delays by investors. [redacted] 25X1

To maintain investment momentum in the longer term, Beijing will need to tackle the more thorny issues that dog foreign investors. Chinese officials have stated that the country's investment climate cannot be changed overnight, but that further amendments will follow. According to Chinese press reports, the State Council is already studying additional regulations to supplement the guidelines. The additional investment incentives, reportedly to be introduced this year, include greater market access for foreign enterprises that produce goods currently imported, with part of the hard currency saved payable to the enterprise. [redacted] 25X1 25X1

In the coming months, we expect Beijing to keep a watchful eye on the implementation of local supplementary incentives, particularly with regard to foreign exchange. If these regional experiments proceed smoothly, we believe Beijing will be ready to undertake the more difficult issues over the next year. [redacted] 25X1

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Doing Business in China: The Litany of Complaints

Complaints about the difficulty and excessive cost of doing business in China largely result from frustration and disappointment among foreign investors who rushed in to take advantage of China's "open door" policy. Many discovered that the opportunity to secure a share of the world's largest untapped potential market was available only under extremely restrictive conditions. Moreover, the Chinese are overly sensitive about being cheated, and measures to guard against this have led to the creation of artificial price structures and resulted in excessive costs. Consequently, in matters involving labor, taxes, customs duties, and living costs, foreign investors have been marked for discriminatory treatment that has made doing business in China often more expensive than in Tokyo or Hong Kong. [redacted] 25X1

Although low labor costs initially attracted many foreign investors to China, the taxes and subsidies levied on the wages of Chinese workers in foreign-funded enterprises significantly increased the cost of labor. Recently, MFERT's Foreign Investment Administration announced that Chinese wages in joint ventures could be up to 150 percent higher than those of workers in state-owned factories. This wage premium, largely pocketed by the government, makes China less competitive than some neighboring countries in Southeast Asia for unskilled labor. [redacted] 25X1

In addition, foreign enterprises are often plagued with poor productivity levels because many state-assigned workers are unqualified. The inability of foreign enterprises to fire incompetent workers and long delays in obtaining more suitable replacements perpetuate the low productivity that, according to some investors, makes production costs higher in China than in Western Europe or the United States. [redacted] 25X1

Furthermore, in its efforts to restrict long-term foreign involvement in its economy, China has carefully limited the penetration of joint ventures in its domestic market, the life expectancy of such joint ventures, and the period of protection of intellectual property. The foreign investor is expected to transfer his technology and management know-how, produce products for export to pay for the transfer, develop markets for these products abroad, and depart after the expiration of his joint venture contract. [redacted] 25X1

China's nonconvertible currency is another major sticking point. Only a few investors--mainly owners of luxury hotels built to accommodate foreign tourists and business executives, which have guaranteed hard currency earnings--are untouched by the problem. But most joint ventures have yet to show a profit in anything but renminbi, a profit of questionable value. [redacted] 25X1

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2 – C/OEA/CH, 4G20
1 – C/OEA/CH/EA, 4G32
1 – C/OEA/CH/IS, 4G32
1 – C/OEA/CH/PA, 4G32
1 – OEA/Production, 4G48
1 – D/OEA, 4F18
1 – DDI, 7E44
1 – D/DCI/DDCI, Executive Staff, 7D60
1 – Senior Panel Review, 5G00

[redacted] 25X1

[redacted] 25X1

1 - PDB Staff, 7E30
1 - NIO/EA, 7E62
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5 - CPAS/IMC/CB, 7G07
1 - Author
5 - Chrono
[redacted] 25X1

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